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SRC Insights

Federal Reserve Bank of Philadelphia

Establish Risk Management Practices that Support CRE Concentrations

by Sharon Wells, Assistant Examiner

Over the last several years, the level of commercial real estate loans at supervised banking institutions has been rising. Because levels are approaching points that have historically resulted in safety and soundness issues during periods of economic and market downturns, the *Interagency Guidance on Concentrations in Commercial Real Estate* (guidance) was issued earlier this year to "remind institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program."[1] Accordingly, the guidance provides a number of best practices an institution can undertake to manage the risk associated with elevated CRE loan levels on its balance sheet.

In order to assist institutions and examiners with a general point of reference in determining when a CRE concentration has reached a level where increased examiner focus and risk management practices may be warranted, the guidance provides two primary criteria. It should be noted that the guidance stresses that these criteria should serve as preliminary screens and are provided as "high-level indicators to identify institutions potentially exposed to CRE concentration risk." They are not set as de facto CRE lending limits. These criteria are as follows:

- The total of loans for construction, land development, and other land is equal to or greater than 100 percent of total risk-based capital.
- The total of loans for construction, land development, and other land *and* loans secured by multi-family and non-farm, non-residential property is equal to or greater than 300 percent of total risk-based capital. In addition, the portfolio must have CRE loan growth of 50 percent or more during the last 36 months.

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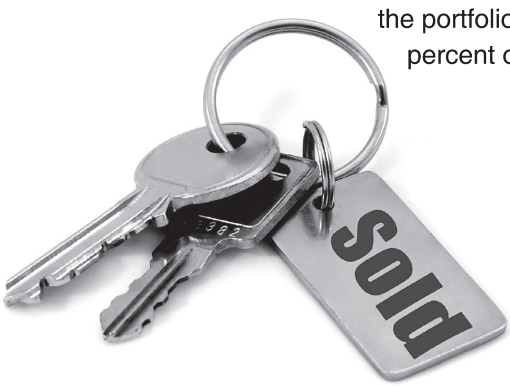

[1] SR Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm>.

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Maintaining Balance Between Risk and Innovation

by Michael E. Collins, Senior Vice President

An important goal for business and banking organizations is to find ways to sustain superior performance in the face of rising complexity, intense competition, rapid advances in technology, increasing globalization, and the growing struggle to find skilled workers.

Banks remain an integral part of the larger financial system, which includes other rapidly evolving financial intermediaries, such as securities, insurance, and private equity firms, as well as hedge funds. The large number of participants and the wide variety of products and services offered have made the financial system fertile ground for rapid change and innovation. Success in this environment requires an effective risk management approach, a balanced regulatory framework, and an awareness of major trends in banking and financial markets.

Recent history suggests that the banking industry is managing operating challenges quite well, and the strong performance of the banking industry over the past several years may correlate directly to strong and continually improving risk management practices. Other drivers of bank performance include sound economic conditions, solid creditworthiness in corporate and household sectors, ample liquidity, lower loan losses, diversity of revenue sources, a strong focus on the customer, innovation in credit markets and risk management, and sound capital.

There are signs, however, that the industry has reached an inflection point. A moderating economy, emerging weaknesses in residential real estate markets, continued net interest margin compression, and intense competition are creating headwinds. To continue to flourish in this environment, the banking industry should ensure that risk management practices and techniques are commensurate with the complex exposures introduced through many of the new products, services, and markets that have proliferated in recent years. As the highly accomplished CEO, Lee Iacocca, once put it, "Every business and every product has risks. You can't get around it." However comfortable the market is with statistical management of risks, and despite innovation, the underlying risks will always remain. And, as always, these risks must be managed properly.

Perhaps the most telling current example of the continued presence of risk despite mitigants is the current state of the subprime mortgage market. We are seeing evidence that the originate-to-distribute approach to lending deployed by banks in subprime loans is slowing, as capital markets are less accepting of subprime and Alt-A loans. While the banking industry is not unduly exposed in the subprime lending market, banks may hold subprime mortgages backed by securities in their investment portfolio. The economic impact on banks is manageable, but there are significant social implications to the rising trend in delinquencies and foreclosures, which is resulting in material reputational risk for banking organizations.

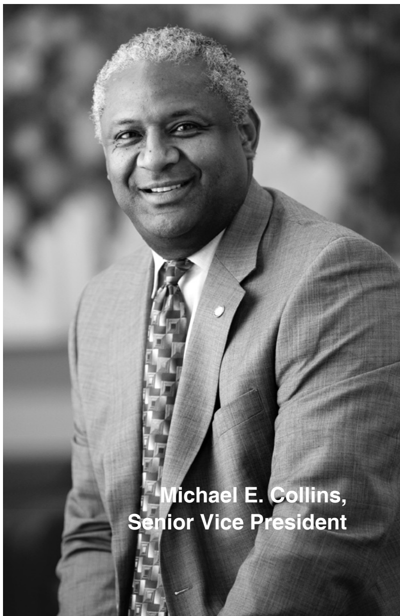
Bank supervisors are aiming to achieve a balance between the costs and benefits of regulation and guidance.

The issues that are affecting the subprime market bear the hallmarks of previous credit cycles, such as credit overexpansion; a belief that asset prices will continue to rise; over-optimism followed by delinquencies, defaults, and failures; rising evidence of fraud; imbalance in credit-risk markets; and the risk of overreaching legislative and regulatory solutions. Several bankers we spoke with have voiced concerns that as regulators and legislators design solutions for the growing foreclosure problem, the solution will stretch too far and impact all lenders, including banks that do not engage in subprime lending. Bank supervisors, however, are aiming to achieve a balance between the costs and benefits of regulation and guidance.

Consistent with this goal, banking supervisors expect regulated institutions to be mindful of the risks posed by new and expanding business activities. Over the years, we have issued several pieces of guidance on sound lending practices to address weaknesses in underwriting and risk management and concerns about abusive practices. The proposed guidance on subprime lending issued in 2006, for example, recommends that repayment capacity include an evaluation of borrowers' ability to repay debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also reminds institutions that they should clearly communicate the risks and features of these products to consumers in a timely manner, before consumers have applied for a loan.

Even more recently, supervisors have issued a statement that encourages institutions to work with mortgage borrowers who are unable to make their payments. The interagency *Statement on Working with Mortgage Borrowers* encourages financial institutions to consider prudential workout arrangements with distressed borrowers and provides guidelines for doing so in a safe and sound manner.

Going forward, we can expect to see corrective tightening of underwriting to persist in response to the current turbulence in the subprime and Alt-A markets. Banks will continue to face challenges such as coping with a continually changing business model, dealing with hyper-competition, and attracting and retaining critical talent. To meet these challenges successfully, banks must have a strong risk management culture and agility and resilience at multiple levels within their organizations. Successful banks will be those that can achieve growth with profitability, implement effective enterprisewide risk management, and integrate the strengths that knit an organization together. ☐


Michael E. Collins, Senior Vice President

The Financial Services Regulatory Relief Act of 2006

by Chris Hahne, Assistant Examiner

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (act).[1] The act is the result of five years of legislative, regulatory, and industry input; Congressional negotiation; and an extensive review of the various federal banking agencies (the agencies) and their guidance. While the final version of the act does not contain some of the broader items that the industry sought, it does contain a number of items that should provide some regulatory relief to financial institutions.

A number of the act's provisions update how the agencies conduct their business, while others clarify or amend portions of the Gramm-Leach-Bliley Act (GLBA). Additionally, the act allows the Federal Reserve to pay interest on certain reserve balances held on deposit at Federal Reserve Banks and gives the Board of Governors of the Federal Reserve greater flexibility in setting reserve requirements. Other provisions modify the regulatory standards for certain types of financial transactions and expand and clarify federal authorities and procedures in sharing data, retaining records, and scheduling examinations.

A brief description of the more salient points that directly affect both regulators and the banking industry are discussed below, followed by a cursory overview of other select provisions of the act. It should be noted that some of the interim rules stated in the act are currently open for public comment.

> The act is the result of five years of legislative, regulatory, and industry input; Congressional negotiation; and an extensive review of the various federal banking agencies and their guidance.

Key Provisions of the Act

The act includes the following key provisions:

- Authorizes the payment of interest on institution balances held at Federal Reserve Banks
- Increases the flexibility of the Federal Reserve to set institution reserve ratios against transaction accounts
- Allows the use of "pass through" accounts for state member and nonmember banks
- Extends the examination cycle for certain depository institutions
- Reduces reporting requirements for financial institutions related to insider lending
- Expands the enforcement authority and removal activities of the federal banking agencies

A brief summary of some of the key elements in these provisions follows. However, all of the changes in the act, including those discussed below, must be considered in their full context and in conjunction with existing laws and regulations.

Interest on reserves and reserve ratios. Among the act's most important provisions are two that relate to reserve requirements. Effective October 1, 2011, the Federal Reserve is authorized to pay interest on reserve balances held by depository institutions in Federal Reserve Banks (Section 201). The act also gives discretion to the Board of Governors (Board) to lower the required reserve ratios for transaction accounts (Section 202).

Additionally, Section 603 provides for member banks of the Federal Reserve System to count as reserves

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[1] The full text of the Financial Services Regulatory Relief Act of 2006 is available online at <http://thomas.loc.gov/cgi-bin/query/z?c109:S.2856.ENR:>.

the deposits in other banks that are "passed through" by those banks to the Federal Reserve as required reserve requirements; nonmember depository institutions are already able to do this.

Examination cycles. Perhaps one of the most significant aspects of the act is Section 605, which increases the asset threshold from $250 million to $500 million for community banks to qualify for an 18-month on-site safety and soundness examination cycle. The expanded examination cycle will be available for institutions that are well-capitalized and well-managed, have a composite CAMELS rating of 1 or 2, and meet certain other qualifying criteria.[2]

Prior to this legislation, depository institutions with greater than $250 million in assets were examined on an annual basis. This change in examination cycles may affect the supervision of a number of depository institutions within the Third District. Federal Reserve Chairman Ben S. Bernanke recently stated that this change in examination cycles "will allow about 1,200 federally-insured institutions to qualify for an extended examination cycle without compromising the safety and soundness" of the institutions.[3]

Insider lending. Section 601 of the act amends the Federal Reserve Act and Bank Holding Company Act by reducing reporting requirements for loans made to insiders who are subject to Regulation O.[4] Though the amendment does not provide any change to the requirements covering extensions of credit, the act repeals certain regulatory reporting requirements for loans to bank executive officers and principal shareholders. Specifically, the following reporting requirements have been repealed:

- The report to the board of directors that is required by Section 215.9 when an executive officer becomes indebted to another institution
- The report that the institution must file under Section 215.10 all extensions of credit made to executive officers since the previous report of condition
- The report to the board of directors that is required by Subpart B of Regulation O, when an executive officer or principal shareholder becomes indebted to a correspondent bank

Enforcement provisions. The act includes a variety of enforcement-related provisions that generally serve to enhance the enforcement and removal authority of the agencies.

- Section 708—Expands the removal and prohibition authority of the federal banking agencies when an institution-affiliated party is the subject of any information, indictment, or complaint, including coverage of individuals who attempt to become involved with an insured depository institution after being so charged Additionally, the statute clarifies that the removal or prohibition extends to any depository institution, not just the institution for which the institution-affiliated party currently serves.
- Section 710—Extends the automatic prohibition on participation in the banking industry if a person is found convicted of a criminal offense involving dishonesty, breach of trust, or money laundering to include noninsured national and state member banks and uninsured offices of foreign banks. Also prohibits an individual so convicted from participating in the affairs of a domestic bank holding company (BHC) or an edge or agreement corporation without the consent of the Board of Governors and from participating in the affairs of a savings and loan holding company or any of its

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[2] See 12 CFR 4.6 and 4.7 (OCC), 12 CFR 208.64 and 211.26 (Board), 12 CFR 337.12 and 347.211 (FDIC), and 12 CFR 563.171 (OTS).

[3] "Banking Regulation and Supervision: Balancing Benefits and Costs," The Federal Reserve Board, Remarks by Chairman Ben S. Bernanke before the Annual Convention of the American Bankers Association in Phoenix, Arizona and the Annual Convention of America's Community Bankers, San Diego, California, October 16, 2006.

[4] The full text of Regulation O, *Loans to Executive Officers, Directors and Principal Shareholders of Member Banks*, is available on the Board of Governors' website at <www.federalreserve.gov/regulations/default.htm#o>.

Nontraditional Lending to Subprime Borrowers—A Viable Path to Homeownership?

by Chris Henderson, Special Advisor

Depending on the source, the increase in subprime lending in recent years has been either a disaster in the making or an innovative way to provide more borrowers a chance at the American dream of homeownership and wealth accumulation. These divergent views bring to mind the "broken window fallacy" introduced by 19th century French economist Frederic Bastiat. He wrote that "To break, to destroy, to dissipate is not to encourage national employment...Destruction is not profitable." In today's environment it remains to be seen whether lending to borrowers who will likely eventually default and experience foreclosure enhances individual prosperity and promotes economic growth in the long run or simply creates financial distress. This article will explore some fundamental aspects of subprime lending in order to better assess whether subprime loans ultimately help or hinder borrowers, as Bastiat's message would suggest.

> The basic structure of nontraditional mortgage products is to exchange lower payments during an initial period for higher payments later.

Subprime Lending and Nontraditional Mortgage Products

Subprime lending is defined as extending credit to borrowers who exhibit characteristics that show a significantly higher risk of default than traditional customers.[1] This article addresses subprime borrowers who have chosen nontraditional mortgage products to finance the purchase of a home.[2] The imploding subprime industry has been the focus of recent media and press headlines, but the link between subprime borrowers who default on their loans and their use of nontraditional products is less apparent. In testimonies before Congress, Federal Reserve officials have clearly made the connection that the recent deterioration in housing credit has been concentrated among a relatively narrow market of subprime borrowers who used adjustable-rate mortgages (ARMs), a common feature among nontraditional loans.[3] The Federal Reserve Bank of Atlanta published an article in its *Financial Update* during the third quarter of 2005, which warned that most subprime mortgage holders would likely see a rise in monthly payments, thereby increasing the risk of foreclosure and the deterioration in the quality of mortgage-backed securities.[4]

The basic structure of nontraditional mortgage prod-

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[1] SR Letter 99-6, *Interagency Guidance on Subprime Lending*, is available on the Board of Governors website at <www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9906.HTM>.

[2] Typically, the term nontraditional mortgages refers only to relatively new higher risk mortgage products, such as interest-only mortgages. In some cases, the issues discussed in this article will also pertain to more traditional affordable products, such as adjustable rate mortgages with initial teaser rates.

[3] See the testimony of Roger T. Cole, Director of Banking Supervision and Regulation, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (March 22, 2007) and the testimony of Sandra F. Braunstein, Director of the Division of Consumer and Community Affairs, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives (March 27, 2007). The two testimonies, however, do not discuss the full nature of the adjustable rate mortgage product. It is assumed in this article that subprime borrowers are using the more risky ARM mortgages that are classified as nontraditional loans.

[4] *Growth of Subprime Mortgage Market Raises Questions* is available on the Federal Reserve Bank of Atlanta's website at <www.frbatlanta.org/invoke.cfm?objectid=9B6D85CD-5056-9F06-99002638F7F6C3D2&method=display>.

ucts is to exchange lower payments during an initial period for higher payments later. This product structure can also include the use of a reduced or no documentation feature in assessing the creditworthiness of the borrower and the simultaneous creation of a second-lien mortgage.[5] Nontraditional loan products were not originally designed for subprime borrowers, but instead were directed at borrowers seeking flexible payment options who could otherwise qualify for prime interest rates. Subprime mortgages, however, are often marketed to applicants as having a low introductory interest rate (teaser rate) or payment plan that usually results in higher fees, mortgage balances, monthly payments, and interest costs in the future. A brief list of common types of nontraditional loans includes:

- Negative Amortization Mortgage—This loan type features low monthly payments, but results in monthly payments that are less than the true amortized amounts. The loan balance increases over the term of the loan rather than decreasing as unpaid interest is added to the loan's principal amount.
- Interest-Only Mortgage—This loan type features lower monthly payments than a conventional mortgage, as the monthly payment only covers the interest owed, and the repayment of principal is deferred. After the interest-only period ends, higher monthly mortgage payments are required to cover both interest and principal.
- Option Payment Adjustable Rate Mortgage (ARM)—This loan type provides the applicant the option of determining the adjustments of the interest rate at specified intervals. Mortgage payments are tied to some index outside the control of the financial institution, such as the interest rates on U.S. Treasury bills or the average national mortgage rate. Under this loan type there is the option to make minimum payments below the amount needed to cover both principle and interest, pay interest only, or make payments where the loan fully amortizes over 15 or 30 years. Regardless of the option, the interest rate on the loan will reset according to the index tied to the loan.
- 40-Year Mortgage—This loan type allows the borrower to pay off the loan in 40 years as opposed to the conventional 30-year period, resulting in a lower monthly payment but higher interest cost.

The common benefit among these loan types is the short-term affordability they provide potential borrowers. As a result, nontraditional mortgages can be viewed as unique products designed for borrowers who have special, short-term circumstances. A subprime borrower who purchases a nontraditional mortgage product would likely represent someone who does not just have impaired credit, but also who would be carrying a high debt relative to income upon obtaining the mortgage. The Federal Reserve's Survey of Consumer Finances (SCF) indicates that, from 1995 to 2004, census tracts in all income groups experienced gains in homeownership, with rates in lower-income tracts growing by 6 percent, somewhat faster than the 4 percent growth rate in higher-income tracts.[6] The SCF data confirm that low income households were likely candidates for nontraditional loans over the last decade.

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[5] The addition of a low- or no-documentation feature is also known as risk layering.

[6] See page 2 of testimony by Sandra F. Braunstein, Director of Division of Consumer and Community Affairs before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives (March 27, 2007).

Today, a subprime borrower might want to purchase a nontraditional mortgage product to obtain housing at a favorable price in anticipation of improved credit, significantly higher future income, and/or cash flow holding other factors constant. However, recent data show that subprime loans have grown from $65 billion in 1995 to $665 billion in 2005, a ten-fold increase over a decade.[7] It is not probable that so many borrowers have temporary, special circumstances that lead them to purchase nontraditional mortgage products. It is more likely that other factors are driving demand for these products. More specifically, nontraditional mortgage products may not be suitable for subprime borrowers who are less likely to have a change in financial circumstances that lead to significantly higher income or cash flow, as it will only result in debilitating household balance sheets in the future.

Consumer Preference for Financing Options

Residential real estate markets have experienced rapid appreciation in recent years. In some California and Florida housing markets, house prices as measured by nominal housing price indices have increased over 90 percent in the last three years due, in part, to market fundamentals and speculative behavior. Rapid house price appreciation can easily make homeownership unattainable for young or low-income borrowers regardless of credit history, thereby making subprime loans a very attractive means to buy a home. When short-term interest rates began to rise steadily in 2004, the option payment ARMs became more popular and extended the housing boom further. While house prices continued to soar, debt burdens simultaneously continued to rise because consumers were extracting equity from their homes to purchase home furnishings and make home improvements since personal savings rates were falling. Higher prices and debt burdens, combined with weak credit histories, created a fertile environment for subprime lending to flourish over the last decade as the desire to purchase and refinance homes grew. In such an environment, consumers preferred more financing options than fewer, and financial institutions were willing to oblige this demand, since interest rates were historically low.

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Regulatory Guidance

Many market participants see marketing to subprime borrowers and the growth of innovative financial instruments, such as nontraditional loans, as leading to the "democratization of credit" that broadens access to homeownership. Others view subprime lending as an insidious form of predatory lending, which would make borrowers more disadvantaged than if they had not received a loan at all, undermining the goal of safety and soundness in banking. The federal banking agencies responded to these concerns by issuing guidance to address the risks to financial institutions posed by nontraditional residential mortgage products. This interagency guidance addressed the sharp increase in the number of financial institutions offering nontraditional mortgage products and the expansion of the market for these products (i.e., borrowers who are less likely to qualify for a similar-size mortgage under traditional terms and underwriting standards). The guidance formally recognizes that it is possible for subprime borrowers (using a credit score-based definition) to obtain nontraditional loans as well.

The guidance details the importance of carefully managing the risk inherent in these loans.[8] Below are

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[7] Inside Mortgage Finance Publications, *The 2006 Mortgage Market Statistical Annual*, is available online at <www.imfpubs.com/catalog/statisticalreports/1000002746-1.html>.

steps from the guidance which financial institutions should take to mitigate the risk.

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity. For example, federal regulators already expect supervised institutions to qualify borrowers based on their ability to meet repayment criteria.
- Recognize that many nontraditional mortgage loans are untested in a stressed environment, particularly when they have risk-layering features (e.g., interest-only mortgages with low documentation features). These products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio.
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

There are specific guidelines within capital adequacy procedures that address subprime lending directly. Additional regulations exist to protect consumers from unscrupulous issuers of subprime loans and other abusive practices such as the Truth in Lending Act (TILA) or Regulation Z, TILA's implementing regulation. TILA was enacted by Congress to inform consumers about the cost of credit so they can make informed credit decisions and to protect consumers against unfair credit practices.[9] Federal regulators require banks to comply with other consumer protection laws that include the Home Mortgage Disclosure Act (HMDA), the Equal Credit Opportunity Act (ECOA), and the Community Reinvestment Act (CRA).

Although CRA and later revisions provided banking institutions a strong incentive to lend in low- and moderate-income areas and in varied racial and ethnic communities, it appears that a significant portion of these loans are subprime loans.[10] As a result, regulatory scrutiny of the subprime lending market is warranted to prevent disparate impacts on particular racial and ethnic groups when market conditions have a disproportionate adverse impact on the subprime market. Academic research suggests that racial disparities may exist in the origination of subprime loans. Immergluck and Wiles (1999) reported that more than half of subprime refinances originated in predominately African-American census tracts, whereas only one-tenth of prime refinances originated in predominately African-American census tracts.[11]

The Current Environment

Indicators of a slowing economy and a relatively low inflation, as well as inflation expectations, have prompted the Federal Reserve to stop its succession of interest rate increases. Job and income growth remain healthy, thereby providing economic support to borrowers who have subprime loans. Although mortgage interest rates have risen modestly beyond their recessionary levels from 2001, mortgage interest rates are still historically low. By the end of 2006, however, the financial press and market analysts have reported that a record number of homeowners with high-cost mortgages have fallen behind on their payments or are facing foreclosure.

The Mortgage Bankers Association quarterly survey noted that approximately 223,000 households with

[8] SR Letter 06-15, *Interagency Guidance on Nontraditional Mortgage Product Risks*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf>.

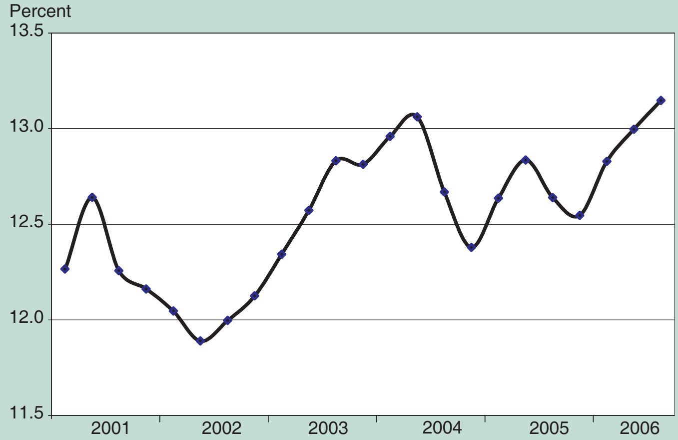
[9] It is outside the scope of this article to address why subprime loans are profitable, growing portfolio segments among financial institutions, but it is very transparent as to why consumers have purchased these types of mortgages at an alarming rate.

[10] These views were first presented by Federal Reserve Governor Edward M. Gramlich in a speech at the Financial Services Roundtable Annual Housing Policy Meeting in Chicago, IL on May 21, 2004.

[11] Immergluck, Daniel and Wiles, Marti, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, Chicago: The Woodstock Institute, 1999.

subprime loans foreclosed on their homes in the third quarter of 2006, and nearly 725,000 subprime borrowers missed payments.[12] A recent study by the Center for Responsible Lending cites that 2.2 million subprime borrowers will lose their homes, one out of five subprime mortgages originated in the past two years will end in foreclosure, and up to $164 billion of wealth (equity) will be lost as housing appreciation slows or reverses.[13] More importantly, the study finds that subprime loans with layered risks such as low or no documentation and prepayment penalties significantly increase the risk of foreclosure after controlling for borrower credit scores. This dismal account of the subprime market has taken place even though long-term interest rates and unemployment rates have remained low.

Vacant Housing Units as a Percent of Total Housing Units



Subprime borrowers tend to have very limited options to avoid foreclosure. These borrowers will most likely either seek to refinance or try to recoup equity by selling their home. *Business Week* reported that more than one-fifth of homes with option ARM loans in 2004 and 2005 are worth less than their debt, and if prices fall, only 10 percent of this number could double. One reason for the housing price decline is increasing residential inventories and vacancies. As residential inventories and vacancies rise, subprime borrowers will be less likely to exercise the two common exit strategies, and they will not be able to escape foreclosure. High residential vacancies are important, as they signal to builders that supply forces are outstripping demand. Also, when an occupied home is sold, the seller will need to either buy or rent another house under normal circumstances. In aggregate, these typical transactions will cause a ripple effect through the economy. When a vacant home is sold, this ripple effect does not occur. The chart below indicates that vacant housing units for sale as a percentage of total housing units has risen sharply since 2002.[14]

Several other factors are creating distress for the subprime borrower:

- Moody's Economy.com estimated that more than $2 trillion of U.S. mortgage debt, or about a quarter of all mortgage loans outstanding, had begun to reset in 2006 and is scheduled to reset in 2007, causing monthly payments on adjustable-rate mortgages to increase.
- Higher debt burdens, lower home equity, higher interest rates, and more prudent risk management among financial institutions will keep borrowers from extracting equity from their homes to pay off existing loans and prevent delinquency or foreclosure.
- Higher energy prices have the effect of a tax on disposable income and have placed additional pressure on household balance sheets.
- Job growth remains stable despite signs that the economy is slowing. The absence of strong job growth might spell trouble for subprime borrowers who could benefit the most from the in-

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[12] The Mortgage Bankers Association (MBA) National Delinquency Survey is available for purchase on the MBA's website at <www.mortgagebankers.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm>.

[13] *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, is available online at <www.responsiblelending.org/pdfs/CRL-foreclosure-rprt-1-8.pdf>.

[14] Lahert, Justin, "Vacant Housing Analysis," *Wall Street Journal*, Janary 8, 2007, C1.

creased income that usually accompanies a robust job market.

Anatomy of a Subprime Loan

The table below shows the typical payment option for an option ARM on a $500,000 loan. Based on an initial rate of 7.38 percent and a 1 percent minimum payment rate, a borrower will have a monthly payment of $1,608.20, and $20,214.81 will get added to the balance of the loan. If the loan will reset a year and a half later to 7.95 percent while the borrower has only made minimum payments and the loan principle reaches 110 percent of the original loan balance, the minimum payment will jump to $4,107.86, and $50,357.28 will be added to the loan balance. It is very easy to see how payment resets can trigger immediate distress to the subprime borrower.

The industry is poised for greater consolidation as many institutions are looking to exit their subprime businesses entirely or sell existing assets.

Payment Options	Monthly Payment	Additional Interest Added to Balance
Fully Amortizing 15-Year Loan	$4,601.03	$0
Fully Amortizing 30-Year Loan	$3,455.08	$0
Interest-Only Payment	$3,073.26	$0
Minimum Payment in Year 1	$1,608.20	$20,214.81
Payment After Reset in Month 29	**$4,107.86**	**$50,357.28**

Data: Keef, Bruyette & Woods Inc.

Conclusion

The segment of the market that offers nontraditional mortgages to subprime borrowers is inherently risky by design, as lenders provide the credit-challenged borrower with greater flexibility around repayment under special circumstances. Those special circumstances usually involve the borrowers' inability to afford the terms of a conventional loan contract due to the prevailing interest rate or required down payment. The market currently views the product as a financial tool to accommodate borrowers with weaker credit histories as opposed to a product that addresses a special, short-term deficiency in the borrower's financial profile. Research shows how borrowers who are currently experiencing financial difficulty or who could become financially vulnerable under a probable market scenario are more likely to default on a subprime loan. Greater mortgage defaults not only harm the borrower, but also depress real estate markets as homeowners exercise their option to walk away from their homes. Higher defaults and foreclosures spell lower profits for institutions that make these loans.

Recent mortgage finance research and financial press reports of known subprime lenders experiencing financial difficulty are not surprising, given that firms in the subprime industry in the past have either failed or were purchased by larger institutions.[15] In April 2007, the financial press reported that New Century Financial Corp., once the nation's second-largest provider of mortgages to high-risk borrowers, filed for bankruptcy protection and fired 54% of its work force. The industry is poised for greater consolidation as many institutions are looking to exit their subprime businesses entirely or sell existing assets. Unless the industry changes its view of underwriting to one where credit is granted by the borrower's ability to repay the loan after the interest rate resets, the important lessons from Bastiat will be ignored, and the efficiency gained from innovative financial instruments will be lost.[16] □

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[15] Chomsisengphet, Souphala and Pennington-Cross, Anthony, "The Evolution of the Subprime Mortgage Market," *Federal Reserve Bank of St. Louis Review*, January/February 2006, 88(1), Table 5, p. 39. See the "Review 2006/Preview 2007: How the Mortgage Subprime Sector May Look Post Shake-out," *American Banker*, January 9, 2007.

[16] Or the borrower can repay the loan without resorting to selling the property or refinancing under pressure.

Establish Risk Management Practices that Support CRE Concentrations *...continued from page 1*

The guidance emphasizes that CRE loans include those loans where the primary source of repayment is the cash flow from the real estate collateral, such as through rental income or the sale of real estate. Examples of loans which would apply would be those secured by multi-family apartment complexes, multi-tenant commercial office buildings, retail strip malls, and self-storage facilities, as well as loans associated with construction and land development or planned tract housing development.

Loans to REITS and unsecured loans to developers should also be considered if their performance is closely linked to the CRE market. Loans for owner-occupied real estate (subject to the 50 percent rule) or real estate taken as an abundance of caution are not considered when evaluating CRE concentration levels.

An institution that determines that a CRE concentration is present is encouraged to review its risk management practices to ensure that they adequately address the potential risk inherent in the portfolio. Bank management and examiners alike should consider the adequacy and presence of the following seven key elements in determining whether an institution's risk management practices are appropriate in light of the level and nature of the bank's CRE concentration risk.

Board and Management Oversight

The board of directors has ultimate responsibility for ensuring that CRE lending activities reflect the bank's appetite for risk and overall strategic goals. Continual monitoring of concentration levels for adverse trends is also important. The board of directors or a committee of board members should establish policy guidelines that outline acceptable levels of CRE exposure and should ensure that management implements procedures and controls to monitor compliance with those policies and procedures. The board should also be reviewing information and reports that identify the nature and level of risk of CRE concentrations and changes in market conditions, and it should periodically review and approve CRE risk exposure limits based on these changes.

Portfolio Management

Institutions should evaluate their portfolio analysis practices to ensure that they adequately reveal concentrations of loans that may be similarly affected by cyclical changes in the CRE market. In general, portfolio analysis and management strategies should include a regular evaluation of the loan portfolio mix and the correlation between sectors, markets, and geographic or economic sectors (e.g., all loans dependent upon the construction industry or all speculative loans). Contingency planning is important as well, and institutions should consider ways by which they might reduce exposure or mitigate concentrations. Contingency plans that include securitizations should be complemented by periodic review of the portfolio's marketability, including an evaluation of secondary market access and the underlying underwriting standards of this source.

Management Information Systems

Management information systems play a key role in providing a proactive approach to adequately managing concentration risk by ensuring that negative portfolio trends are known ahead of time. A financial institution's information systems should provide management with sufficient information to identify, measure, and monitor loan portfolio characteristics on both the macro and micro levels. By not only identifying the gross level of total CRE loans against total capital, but by also stratifying the CRE portfolio into more detailed segments, management can target those markets, property types, or loan types which warrant the most focus and attention. Examples of portfolio stratification include tracking portfolio composition by property type, geographic market, tenant or developer concentrations, and quantitative metrics like LTV levels, debt service coverage levels, vacancy rates, absorption rates, and property sales trends. The adequacy of an MIS should be evaluated on an ongoing basis to ensure its relevance amid changes in risk dynamics.

An institution's underwriting standards should reflect the level of risk that is acceptable to the board of directors.

Market Analysis

A program of ongoing market analysis will provide board members, management, and lenders with information needed to anticipate downturns in the overall market and in varying sectors or geographic regions. Institutions should perform periodic market analyses based on both geographic distinctions and the various property types within the CRE portfolio. An institution's strategic planning should reflect the results of its market analysis. Decisions to expand CRE lending activities into new markets, increase activities in existing markets, or introduce new CRE lending products should be supported by adequate market analysis. The guidance does not highlight specific requirements for market analysis, but emphasizes that it should demonstrate that an institution "understands the economic and business factors" that could influence the markets that it serves.

Credit Underwriting Standards

Credit underwriting standards should reflect actual and anticipated changes in the economic and business climate. Banking institutions with high CRE concentrations in their loan portfolios should review and re-evaluate the adequacy and appropriateness of present credit underwriting standards. For example, an institution with a strong historical C&I portfolio that has experienced migration into CRE lending should consider aligning credit underwriting standards to reflect the specialized nature of CRE lending, in addition to any increased risk associated with the types of CRE loans originated.

An institution's underwriting standards should reflect the level of risk that is acceptable to the board of directors. It should provide the lending staff with a framework to adequately evaluate fundamental credit factors such as debt repayment, collateral, guarantor and management strength, and industry/geographic considerations. Credit underwriting standards should also be based on formalized policies and procedures outlining elements such as loan terms, collateral valuation requirements and methodologies, LTV limits, feasibility study and sensitivity analysis requirements, equity requirements, and minimum cash flow/debt coverage requirements. For banks involved in construction lending, policies and procedures which reflect the specialized nature and potential increased risk during construction phases should be maintained. Policies and procedures should address loan disbursement monitoring, construction and inspection documentation, and ongoing project status reports such as sales/lease absorption and actual-to-budget performance.

Portfolio Stress Testing and Sensitivity Analysis

Portfolio risk management should be supported by periodically stress testing the portfolio, which will help management understand the impact that changing economic conditions may have on overall asset quality, earnings, and capital. Stress testing helps to set tolerance limits during strategic planning and to promote proactive versus reactive alternative strategies when unforeseen changes in the economic environment occur.

At a minimum, stress testing should be relevant to the institution and should reflect the size, complexity, and risk characteristics of the portfolio by emphasizing the more vulnerable segments of a CRE portfolio. Increased vacancy rates, slower absorption/sellout rates, and the repayment impact of loan re-pricing are just a few considerations that should be made. In general, the sophistication level of the stress testing models or practices should be in line with the overall inherent risk in the portfolio and the institution's size and resources.

Credit Risk Review Function

Continued oversight of the bank's CRE portfolio can also be accomplished through a formalized and independent credit risk review function. A strong credit review function, either in-house or outsourced to a qualified third-party vendor, assists management with an assessment of emerging risks; provides a system for early identification of problem loans; and identifies potential weaknesses in underwriting, portfolio management, or documentation quality. At a minimum, the credit risk review function should include a risk rating system that is risk-sensitive and objective, promotes portfolio review intervals, and provides for the ongoing review of the appropriateness of the overall credit risk rating system and credit risk review function.

Summary

In summary, the new guidance provides institutions and examiners with criteria that serve as a point of reference in identifying a concentration that may warrant enhanced review and oversight. It also provides suggested risk management best practices to help institutions assess, monitor, and control potential vulnerabilities to economic and market fluctuations so losses can be minimized and capital levels can be sustained. Bankers and examiners are encouraged to refer to the formal guidance for additional information. □

The Financial Services Regulatory Relief Act of 2006

...continued from page 5

nonthrift subsidiaries without the consent of the Office of Thrift Supervision (OTS). Gives the Board of Governors greater discretion to prevent convicted individuals from participating in the affairs of a nonbank subsidiary of a BHC. Provides the Board of Governors and the OTS permission to grant exceptions from this prohibition to BHCs and savings and loan holding companies, respectively.

- Section 702—Among other provisions, clarifies that the agencies may enforce any condition imposed in writing in connection with any application or any Written Agreement entered into between the agency and a depository institution or institution-affiliated party (IAP) (particularly those in which the IAP or controlling shareholder agrees to provide capital to the depository institution) without the requirement that the agency must prove that there is unjust enrichment by the IAP or limiting recovery to five percent of the depository institution's assets at the time the institution became undercapitalized.
- Section 715—Among other provisions, clarifies that the federal banking agencies may initiate an enforcement action by notice or order against any institution-affiliated party, regardless of whether the institution-affiliated party resigned from the depository institution.

There are a number of other provisions that are included in the act that affect the banking industry. Highlights of some of the more significant provisions are described below.

Broker Relief

Section 101 of the act directs the Securities and Exchange Commission (SEC) and the Federal Reserve, in consultation with the other federal banking agencies, to adopt final rules to implement the exceptions to the definition of "broker" under Section 3(a)(4) of the Securities and Exchange Act of 1934 as amended by GLBA. While the SEC has longstanding proposed rules that have generated significant controversy in the industry, they have not been implemented. The SEC announced in September 2006 that final rules would be issued by early summer 2007.

The new rulemaking process provides depository institutions the opportunity to align more closely with the specific exemptions in GLBA and the bank securities transactional services common in the industry at the time of GLBA's enactment. In addition, federal savings associations were exempted by the act from investment advisor and broker-dealer regulations to the same extent that banks are otherwise exempt.

The Financial Services Relief Act of 2006 contains a number of provisions aimed at reducing the overall regulatory burden on depository institutions.

Other Noteworthy Provisions

Section 604 directs the agencies to review certain information and schedules required to be filed in a report of condition every five years to determine whether the continued collection of such information or schedules is no longer necessary or appropriate.

Section 728 of the act directs eight federal regulators (the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Trade Commission, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission) (the privacy agencies) to develop model privacy notice forms to implement the privacy provisions of GLBA.

The act specifies that the model forms must be comprehensible to consumers, with a clear format and design; provide for clear and conspicuous disclosures; enable consumers to easily identify the sharing practices of a financial institution and compare privacy practices among financial institutions; and be succinct, with an easily readable font. On March 21, 2007, the privacy agencies announced a proposed rulemaking for the model forms they developed, for which they are seeking comments.[5]

Under the act's safe harbor provision, financial institutions adopting the model forms will be deemed compliant with the GLBA notice requirements. Because the model forms will supersede the sample clauses currently contained in GLBA, the safe harbor for the sample clauses will expire for notices provided more than one year after the date of publication of a final rule for the model forms. Financial institutions wanting to take advantage of the safe harbor should therefore adopt the model forms once the privacy agencies announce their final rule.

Finally, sections 1001 and 1002 of the act direct that the Comptroller General conduct a study and report to Congress on various matters pertaining to anti-money laundering reporting issues; regulatory oversight and charter options for depository institutions based on size, complexity, and diversity; and possible efficiencies from consolidation of financial regulators and charter simplification.

Conclusion

The Financial Services Relief Act of 2006 contains a number of provisions aimed at reducing the overall regulatory burden on depository institutions. The goal is to provide some level of regulatory relief, a gain of efficiencies, and assistance to improve productivity for financial institutions and the federal banking agencies. ☐

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[5] The proposed rulemaking can be viewed on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/bcreg/2007/20070321/>.

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